

**LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

200 W. Washington, Suite 301
Indianapolis, IN 46204
(317) 233-0696
<http://www.in.gov/legislative>

FISCAL IMPACT STATEMENT

LS 7834

BILL NUMBER: SB 1

NOTE PREPARED: Feb 11, 2005

BILL AMENDED: Feb 10, 2005

SUBJECT: Tax Incentives.

FIRST AUTHOR: Sen. Ford

FIRST SPONSOR:

BILL STATUS: CR Adopted - 1st House

FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: (Amended) *Abatements and TIF Areas:* This bill extends the termination date for authority to approve new property tax abatements or to establish new tax increment finance (TIF) areas from December 31, 2005, to December 31, 2010. It repeals the limitation of tax abatements for new logistical distribution equipment and new information technology equipment to certain counties located along Interstate Highway 69. The bill requires the filing of a personal property return schedule to apply for personal property tax abatement (instead of filing a separate application deduction) and provides that if the township assessor or county assessor does not deny the application, the abatement applies in the amount claimed or in an amount determined by the township assessor or county assessor.

Property Tax Investment Deduction: This bill establishes a property tax investment deduction in declining amounts over three years for certain real property development, redevelopment, or rehabilitation that increases assessed value and creates or retains employment. It limits the deduction to \$2,000,000 of assessed value per year for real property located in a county and restricts the application of the deduction to property first assessed or installed before March 2, 2009. The bill establishes a similar deduction for the installation of personal property other than inventory subject to the same conditions and limitation.

Sales Tax Exemption/Credit: This bill expands the sales tax exemption for tangible personal property used by professional motor vehicle racing teams. It exempts a person from 100% of the sales tax on research and development equipment acquired after June 30, 2007. The bill also provides a refund of 50% of the sales taxes paid on transactions involving research and development equipment acquired after June 30, 2005, and before July 1, 2007.

Research Expense Credit: The bill increases the qualified research expense credit from 10% to 15% on the first \$1,000,000 of investment for taxable years beginning after December 31, 2007. It reduces from 15 to 10 the number of years for which a taxpayer may carry over a research expense credit.

Venture Capital Investment Tax Credit: This bill excludes certain debt provided by a financial institution after May 15, 2005, from the definition of "qualified investment capital" that is eligible for the venture capital investment tax credit. It specifies that a business primarily focused on professional motor vehicle racing is eligible for certification as a qualified Indiana business for purposes of the venture capital investment tax credit. The bill increases the total amount of venture capital investment tax credits that may be allowed in a calendar year from \$10,000,000 to \$12,500,000. The bill also provides that a taxpayer may not carry over a venture capital investment credit for more than five taxable years following the first taxable year in which the credit is claimed.

This bill also makes technical changes.

Effective Date: January 1, 2005 (retroactive); May 15, 2005; July 1, 2005; January 1, 2006.

Explanation of State Expenditures: (Revised) *Department of State Revenue (DOR):* The DOR will incur additional expenses to revise tax forms, instructions, and computer programs to reflect the changes contained in this bill. The DOR's current level of resources should be sufficient to implement these changes.

Venture Capital Investment Tax Credit: The bill extends eligibility for the Venture Capital Investment Tax Credit to businesses primarily focused on professional motor vehicle racing. This could potentially result in a minimal increase in the number of businesses that annually seek certification for the credit. The Indiana Economic Development Corporation (IEDC) should have sufficient resources to implement this change.

Explanation of State Revenues: (Revised) *Abatements and TIF Areas:* The state levies a small tax rate on property for State Fair and State Forestry. Any change in the amount granted for abatements or TIFs would change the amount received from this tax.

If there is an increase in investment because of the changes in this bill, the new property would, at some point, be placed on the tax rolls and the State Fair and State Forestry funds would receive increased revenues. If the investment would have been made with or without the abatement, then increased revenues to the State Fair and State Forestry funds would be foregone until the property is placed on the tax rolls.

Sales Tax Exemption for Professional Motor Vehicle Racing Teams: This bill exempts from the state's Sales Tax tangible personal property that:

- (1) is leased, owned, or operated by a professional racing team; and
- (2) comprises any part of a professional motor racing vehicle, excluding tires and accessories.

The Department of State Revenue (DOR) published *Information Bulletin #67* which states that "a racing vehicle purchased by a professional racing team is exempt from Indiana Sales and Use Tax except for the tires and accessories. Therefore, this bill codifies the DOR's interpretation of the current exemption under IC 6-2.5-5-37.

Research and Development Sales Tax Exemption/Credit: This bill provides a refund of 50% of the Sales

Taxes paid on transactions involving research and development equipment for FY 2006 and FY 2007. The bill provides an exemption from 100% of the Sales Tax on research and development equipment beginning in FY 2008.

The 50% refund is estimated to reduce state Sales Tax revenue by approximately \$11.4 M to \$28.3 M in FY 2006, and \$12.6 M to \$31.3 M in FY 2007. The exemption that begins in FY 2008 is estimated to reduce Sales Tax revenue by approximately \$26 M to \$64 M in FY 2008.

Sales Tax revenue is deposited in the Property Tax Replacement Fund (50%), the state General Fund (49.192%), the Public Mass Transportation Fund (0.635%), the Commuter Rail Service Fund (0.14%), and the Industrial Rail Service Fund (0.033%).

The estimate above is based on data obtained from the National Science Foundation (NSF) that describes the total value of industrial research and development performed in Indiana through CY 2000. Based on past R&D expenditures and adjusting for historical growth, it is estimated that in FY2006, Indiana firms will expend a total of approximately \$2,944 M on R&D in Indiana. In FY 2007, these expenditures are expected to increase to \$2,984 M. Using NSF information on how R&D funds are spent, it is estimated that approximately 14% to 35% of Indiana R&D expenditures would be subject to the state's Sales Tax.

Research Expense Income Tax Credit: This bill increases the credit from 10% to 15% on the first \$1,000,000 of investment for tax years beginning January 1, 2008. The bill also reduces from 15 to 10 the number of years for which a taxpayer may carry over a research expense credit. The incremental revenue loss from increasing the rate of this credit is estimated to be \$1.5 M. However, the increase in the state's liability for this credit could potentially be \$2.2 M annually, with \$.6 M in liabilities being carried forward each year due to the fact that businesses qualifying for credits may have insufficient tax liabilities to use the credits earned during the taxable year. The potential increase cost of this credit would depend on the frequency and cost of future research activities and income growth of taxpayers making creditable research expenditures. This increase in the amount of credit would affect revenue collections beginning in FY 2008 and years after.

Background: P.L. 242-2002 (ss) increased this credit from 5% to 10% of qualified expenses for tax years beginning January 1, 2003, and eliminated the apportionment factor used to calculate the credit. P.L. 81-2004 made this tax credit permanent. This bill will increase the credit to 15% with tax years beginning January 1, 2008.

The Research Expense Credit is available for individuals, corporations, limited liability companies, limited liability partnerships, trusts, or partnerships who have increased research activities conducted in Indiana. The credit is calculated based on the increased expenses a taxpayer incurred over their base year expenditures. The base year expenditures are measured for taxable years beginning after December 31, 1989, and are equal to the federal base amount as defined in the Internal Revenue Code (2001). A taxpayer is not entitled to a carryback or refund, but may carry forward the tax credit for 15 years. The base year expenses may not be less than 50% of the current tax year's qualified research expenses.

Preliminary data on the amount of credits claimed after the changes made by P.L. 242-2002(ss) suggest that approximately \$48 M in credits have been *claimed* in the 2003 tax year. This suggests that the base of the potential credits almost doubled over prior levels. However, since there is currently such a large number of suspended returns, DOR is unable to report the level of actual credits *utilized* for tax year 2003, which would indicate the direct and immediate revenue loss from the changes in the rate and base of the credit. A simulation

of taxpayers suggests that the increase in the rate from 5% to 10% double the amount of potential credits *claimed*, but only 80% of these credits would be *utilized* and 20% of the credits would be carried forward. This simulation also suggested that an increase in the rate of the credit from 10% to 15% on the first \$1M investment would increase the amounts of credits *claimed* by another \$1.5 M, with \$0.6M of the credits being carried forward. Tax year 2001 tax return data indicates that almost 89% of individual filers reporting some business net income had income tax liabilities of \$3,400 or less. For the same year, 88% of corporate filers had income tax liabilities of \$10,000 or less.

A history of the Research Expense Credits taken on the individual and corporate tax returns for the last five years is reported in the table below.

| History of Research Expense Credits Utilized | | | | |
|--|-----------------|---------------------------|--------------------------|----------------------|
| Tax Year | Tax Rate | Indiv. AGI Credits | Corp. Tax Credits | Total Credits |
| 1999 | 5% | \$1.6 M | \$25.8 M | \$27.4 M |
| 2000 | 5% | \$1.6 M | \$18.1 M | \$19.7 M |
| 2001 | 5% | \$1.2 M | \$21.6 M | \$22.8 M |
| 2002* | 5% | \$1.3 M | \$12.3 M * | \$13.6 M * |
| 2003* | 10% | \$2.2 M | \$14.0 M * | \$16.2 M * |
| * 2002 & 2003 tax year estimates are preliminary due to a large number of suspended returns. | | | | |

The additional 5% credit on the first \$1M in new research expenses would provide an additional \$50,000 tax credit. Consequently, increased expenditures on research activities could also generate additional Adjusted Gross Income and Sales Tax revenue if these expenses are used to hire additional employees or purchase related equipment. Assuming this economic impact would not have happened absent this incentive, the actual revenue loss from this credit would be mitigated by the incremental increase in other taxes generated by the research activities.

The Research Expense Tax Credit affects revenue collections deposited in the General Fund and the Property Tax Replacement Fund.

Venture Capital Investment (VCI) Tax Credit: The bill makes the following changes to the VCI Tax Credit.

(1) The bill increases the annual aggregate limit on VCI credits that may be claimed by investors for venture capital investment in qualified companies. The bill increases the annual credit limit from \$10 M to \$12.5 M, beginning in calendar year 2005. The potential annual increase of \$2.5 M in credits claimed for the period 2005 through 2008 could potentially increase the total cost of the credit by \$10 M before it expires. However, the additional fiscal impact depends on action by the IEDC to certify companies for purposes of the credit, and by investors to follow through with creditable investment.

In 2004, 42 companies were designated as qualified to receive venture capital investment for which the investors could claim VCI credits. For 2004, about \$16.3 M in credits were committed to these companies

based on their proposed investment levels. However, only \$10 M in credits could be claimed by investors due to the annual aggregate credit limit set under current statute. At this time, the investors have made sufficient investment in the 42 qualified companies to claim approximately \$3.8 M of the 2004 committed tax credits. Under current law, a taxpayer may claim the VCI credits against the State Gross Retail and Use Tax, Adjusted Gross Income (AGI) Tax, Financial Institutions Tax, or Insurance Premiums Tax liability.

(2) The bill limits the carry forward of unused VCI credits to five years. Under current statute, there is no limit the carry forward period. The impact of this change is indeterminable as data is unavailable relating to credit use and carry forward.

(3) The bill extends eligibility for the VCI Tax Credit to businesses primarily focused on professional motor vehicle racing. This provision could potentially increase the number of businesses qualifying for the credit, but would not increase the fiscal impact of the tax credit due to the annual limit on new credits.

(4) The bill excludes certain secured debt financing of financial institutions from qualifying for the VCI Tax Credit. This exclusion would apply to debt financing provided by a financial institution after May 15, 2005, if it is secured by a mortgage or other agreement that establishes a collateral or security position for the financial institution that is senior to collateral or security interests of other investors in the qualified company.

The Venture Capital Investment Tax Credit is a nonrefundable tax credit equal to the lesser of: (1) 20% of qualified investment capital (debt or equity capital) provided to a *qualified Indiana business* during a calendar year; or (2) \$500,000. The tax credit is allowed for venture capital investment made from January 1, 2004, to December 31, 2008. Under current law, a taxpayer may claim the credit against the State Gross Retail and Use Tax, Adjusted Gross Income (AGI) Tax, Financial Institutions Tax, or Insurance Premiums Tax liability. While the tax credit is nonrefundable, it may be carried forward to subsequent years. No carryback of the tax credit is allowed. Current statute sets an annual limit equal to \$10 M on the total new credits certified by the IEDC for venture capital investment. A taxpayer must provide the venture capital investment to the qualified company within two years. Carryover credits claimed in a taxable year are not counted toward the \$10 M annual maximum.

Explanation of Local Expenditures:

Explanation of Local Revenues: (Revised) *Abatements and TIF Areas:* Under current law, real property, new manufacturing equipment and new research and development equipment may qualify for property tax abatements. The abatements may be granted for periods up to ten years. Currently, no new abatements can be granted after December 31, 2005.

Under current law, TIFs may be established for periods of up to 50 years. Proceeds from TIF allocations may be used to:

1. Pay debt service on obligations incurred for the financing of redevelopment in the allocation area;
2. Deposit funds into a debt service reserve to pay bonds;
3. Pay debt service on bonds used to pay for local improvements in or serving the allocation area;
4. Pay premiums on early bond redemptions;
5. Make lease payments;
6. Reimburse the local unit for the cost of making local improvements;
7. Reimburse the local unit for rent paid by the unit for a building or parking facility in or serving the allocation area;

8. Pay a PTRC-like credit to taxpayers in the allocation area;
9. Pay expenses incurred by the redevelopment commission for public improvements in or serving the allocation area; and
10. Reimburse public and private parties for expenses in training employees of certain industrial facilities.

Currently, no new TIFs may be created after December 31, 2005.

This bill extends the December 31, 2005 deadline to December 31, 2010 for granting abatements and establishing TIFs. If there is an increase in development because of the continued use of abatements and TIFs, the new property would, at some point, be placed on the tax rolls. For abatements this could help spread the property tax burden and could possibly reduce some tax rates, and for TIF areas it increases revenue for the redevelopment commission. However, if one assumes that the investment would be made with or without the abatement or TIF, any increase in abatements (ERAs) and TIFs could also cause a delay in the shift of the property tax burden from all taxpayers to the owners of the new property until the property is placed on the tax rolls. In all cases, the granting of an abatement or TIF is a local decision.

The impact would depend on the value of new abatements and TIFs that might be granted after CY 2005 and before CY 2011 under this provision. The following chart shows the AV for real and personal property abatements and total TIFs for the last 10 years.

| Year | Abatements | | | | TIFs | |
|------|--------------|--------------|--------------|--------------|--------------|--------------|
| | Real | Personal | Total | Increase | Total | Increase |
| 1994 | \$41,790,975 | \$54,579,109 | \$96,370,085 | | \$23,116,487 | |
| 1995 | 42,660,544 | 44,913,061 | 87,573,605 | (8,796,480) | 27,555,225 | 4,438,738 |
| 1996 | 39,409,092 | 66,760,681 | 106,169,772 | 18,596,168 | 32,003,233 | 4,448,008 |
| 1997 | 41,483,134 | 49,280,601 | 90,763,735 | (15,406,038) | 31,998,229 | (5,004) |
| 1998 | 43,312,527 | 43,532,906 | 86,845,433 | (3,918,302) | 38,078,710 | 6,080,481 |
| 1999 | 47,739,446 | 49,989,013 | 97,728,459 | 10,883,026 | 40,528,120 | 2,449,410 |
| 2000 | 50,877,703 | 70,955,197 | 121,832,900 | 24,104,441 | 51,193,949 | 10,665,829 |
| 2001 | 57,247,336 | 94,062,035 | 151,309,370 | 29,476,471 | 29,191,747 | (22,002,202) |
| 2002 | 65,621,529 | 102,594,325 | 168,215,854 | 16,906,484 | 44,379,676 | 15,187,929 |
| 2003 | 59,113,642 | 154,181,896 | 213,295,539 | 45,079,685 | 29,950,248 | (14,429,428) |

Current law authorizes abatements for new “logistical distribution equipment and new “information technology (IT) equipment if it is installed (1) by December 31, 2005 and (2) in an economic revitalization area of a county located within a 107 mile stretch of I-69. Under this provision, the abatement would be available for logistical distribution and IT equipment installed in any economic revitalization area of any county. The bill would also delay the December 31, 2005, deadline for these abatements to be granted to December 31, 2010.

Logistical distribution equipment is defined as racks, scanners, separators, conveyors, forklifts, moving equipment, packaging equipment, sorting and picking equipment, and software. IT equipment is defined as equipment and software used in the fields of information processing, office automation, telecommunication facilities and networks, informatics, network administration, software development, and fiber optics.

Abatement Filing: Under current law, taxpayers annually file a deduction application with the county auditor for personal property abatements. The county auditor must review the application and may request assistance from the township assessor. The county auditor must then approve, deny, or alter the deduction amount.

Taxpayer appeals are currently made to the county court.

Under this provision, taxpayers would instead file a deduction schedule with the township assessor as part of the personal property return. The township assessor would forward the schedule to the county auditor and county assessor. Both the county and township assessors would be permitted to review and deny or alter the amount of the deduction before March 1 of the following year. The county auditor would be required to apply the full or altered (if altered by an assessor) deduction amount if the claim is not denied before March 1. If either assessor denies or alters the claim, then the assessor taking the action would notify the county auditor and the taxpayer. The taxpayer may appeal a change or denial within 45 days by requesting a preliminary conference with the appropriate assessor. Appeals would then follow the usual appeal process for property tax-related matters.

Property Tax Investment Deduction: Under this provision, the increase in assessed value (AV) from certain real and personal property additions would qualify for property tax deductions over a period of three years. The deduction would apply if the property owner creates or retains jobs because of the project.

The deduction would apply to:

1. Real property AV that is added due to development, redevelopment, or rehabilitation; and
2. Personal property installed by the owner that was never before used by its owner in Indiana.

The real property deduction would not be available for the following facilities: golf courses, country clubs, massage parlors, tennis clubs, racetracks, package liquor stores, residential property unless it is low income or in a residentially distressed area, or facilities for skating, racquet sport, hot tubs, suntans, retail food and beverage sales, automobile sales or service, or other retail facilities.

The deductions for both real and personal property would equal 50% of the AV increase in the first assessment year, 33% in the second year, and 16.5% in the third year. Each deduction would be limited to \$2M AV. The real and personal property deductions are separate deductions and would each have a \$2M limit.

Taxpayers would not be permitted to claim more than one deduction for which the project may qualify. So, for example, a taxpayer could not claim both an abatement and this deduction on the same property. Taxpayers who are located in a TIF area would not be eligible for the deduction.

The real property deduction is much like the existing 3-year abatement for real property, but at one-half of the deduction amount. The personal property deduction differs from the current personal property abatement in that the current abatement is available only for manufacturing, research, and logistic equipment. The proposed deduction has no such requirement on the use of the equipment.

The eligible real property would be identified by the township assessor, and the deduction would be granted by the county auditor without application by the taxpayer. Taxpayers seeking the personal property deduction would have to claim the deduction on their personal property tax return.

The investment deduction would slow the growth of both real and personal property AV for property that would have been put in place regardless of the deduction. If there is an increase in development because of the availability of the deduction, then the new property would provide for an increase in the tax base.

Tax shifts between existing and new or rehabilitated property. Generally speaking, the addition of assessed

value to the tax base provides a tax shift from existing property to new property by spreading the tax levy over a larger tax base. The proposed deduction would slow this shift as it pertains to property that would have been put in place regardless of the deduction. This shift could also be accelerated if the availability of the deduction results in an increase in development.

Tax shifts between property classes. The varying rates at which assessed values in each class of property grow in relation to each other determine each class's relative share of the tax burden. The extent to which the growth rate for businesses is affected by this bill will determine whether any tax shifts will occur between classes. Regarding property that would have been put in place regardless of the deduction, this bill would shift some taxes from businesses to other property classes. However, any increase in development that is spurred by the deduction would shift taxes from non-business property classes to businesses.

State Agencies Affected: Indiana Economic Development Corporation; EDGE Board; Department of Local Government Finance; Department of State Revenue.

Local Agencies Affected:

Information Sources: National Science Foundation, *Survey of Industry Research and Development*; Township assessors; County auditors; Department of State Revenue. Lynette Curtis, Indiana Department of Commerce, (317) 232-8898.

Fiscal Analyst: Bob Sigalow, 317-232-9859; Jim Landers, 317-232-9869; Adam Brown, 317-232-9854; Diane Powers, 317-232-9853.